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E.O. 12958: DECL: 09/03/2019
TAGS: ECON EFIN IS
SUBJECT: THE WAY FORWARD ON FISCAL ISSUES FROM THE 2009 JEDG

REF: TEL AVIV 1948

Classified By: Economic Counselor David Burnett for reasons 1.5 b and d .

¶1. (C/NF) Summary: The United States pressed Israel at the 2009 JEDG to consider creating a budget "watchdog" group and institute a new, more effective fiscal rule. In follow-up meetings with Treasury and Emboffs, all three major economic actors in Israel's government agreed with the necessity of a fiscal watchdog, but disagreed on where it could be housed. While the National Economic Council (NEC) and Central Bank agree with U.S. suggestions on a new fiscal rule, senior Ministry of Finance officials have been slow to move on instituting a new rule, and Ministry staff do not believe Israel can practically guide medium-term spending. Going forward, Treasury recommends the USG, in a coordinated effort, (A) press senior Ministry of Finance officials to enact a new, effective fiscal rule as soon as possible; (B) encourage senior Israeli policymakers to examine candidates for a fiscal watchdog; and (C) approach the three major Israeli economic actors in advance of the JEDG Mid-Year Review on possible changes to conditionality to help Israel move towards a fiscal rule and strengthened budget oversight. End Summary.

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The U.S. presses Israel on fiscal issues at the 2009 JEDG
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¶2. (C/NF) Israel likely faces a difficult fiscal outlook after 2011 (see reftel), with debt-to-GDP likely rising towards 100% of GDP by the middle of the next decade. This negative outlook is mainly due to: (1) inadequate projections of the medium- and long-term budget effects of government spending mandates; (2) a lack of oversight of politically-motivated spending projections; and (3) a lack of constraints or anchors for medium-term spending. The United States pressed Israel at the 2009 JEDG to create internal anchors and institutions to constrain medium-term spending, given the (A) impending phase-out of external budget anchors provided by U.S. loan guarantees; (B) recent lack of political clout and capacity of the Ministry of Finance (MoF) to adequately control spending in Israel's budget; and (C) difficulties in providing additional U.S. economic support if Israel encounters serious fiscal strains given the current U.S. fiscal position. These anchors include additional budget oversight and accountability mechanisms, such as the creation of a budget "watchdog" group, and the institution of a new, more effective fiscal rule that would guide

medium-term domestic spending.

NEC, Bank of Israel onboard with U.S. proposals

¶3. (C/NF) In meetings following up on the 2009 JEDG, U.S. officials visited the three major players in Israeli fiscal policy - the National Economic Council (NEC), housed within the Prime Minister's Office, the Bank of Israel (BoI), and the MoF Budget Office - to further explain U.S. views conveyed at the JEDG and gauge Israel's response to U.S. proposals. The NEC and BoI both supported USG proposals that (1) Israel implement a new fiscal rule as soon as possible; (2) a fiscal rule include a direct link between yearly spending targets and the debt-to-GDP "goal;" (3) all long-term spending written into Israel's yearly budgets be scored and comply with the rule's spending caps; and (4) Israel enhance independent budget oversight through a CBO-like body that consults Israel's governing coalition. Note: At present, long-term spending must only comply with the fiscal rule for three years, and there exists little effective oversight of Ministry of Finance budget projections. End Note.

¶4. (C/NF) Although the NEC and BoI continue to differ in the details of their fiscal rule proposals, both institutions described their differences as "technical" and reported that they could come to a compromise position if directed. When asked why they have not come to an agreement, both institutions cited a "lack of urgency" by senior Ministry of Finance officials to move forward on fiscal rule discussions. Both institutions also urged U.S. authorities to press the MoF if we deem a new fiscal rule a priority, arguing that U.S. interest could strengthen the case of civil servants within the MoF to adopt a new rule quickly.

MoF Deputy Budget Director Epstein skeptical of budget reform

¶5. (C/NF) Ministry of Finance Deputy Budget Director Eyal Epstein, while in agreement that Israel should have a new fiscal rule that connects a long-term debt-to-GDP goal with yearly fiscal targets, argued that uncertainty over future emergency costs (such as economic stimuli and conflict spending) make any attempt at trying to plan long-term spending unrealistic. When asked if Israel could set aside funding for average yearly emergency costs (per the BoI's proposal, and following U.S. budget practices), Epstein argued that past attempts to do this failed. Note: The Bank of Israel later explained that Israel's yearly emergency account is usually diverted elsewhere during the budget's debate in the Knesset, leaving little money to cover real emergencies. End note. When asked how Israel can prepare for its uncertain fiscal outlook, Epstein argued that the Ministry of Finance will be able to "crunch" spending each year past 2011, even given the MoF's recent loss of clout to shape the budget-making process.

¶6. (C/NF) Mr. Epstein also criticized the NEC's and BOI's fiscal rule proposals of a calculated yearly deficit cap based on Israel's distance from the debt-to-GDP ratio "goal" as too dependent on exchange rate fluctuations, and proposed his own rule, which would tie pre-defined spending caps to debt-to-GDP "ranges," where, for example, if Israel's debt-to-GDP ratio were between 70% and 80%, real spending growth would be capped at 2%. Mr. Epstein's proposal, however, could be pro-cyclical without proper escape clauses as it could force Israel to cut spending in years where the deficit rises between pre-defined debt "ranges," regardless of whether the deficit was spurred by an economic downturn.

¶7. (C/NF) When prompted for the Ministry of Finance's timeline to present a new fiscal rule proposal to the Israeli Cabinet, Mr. Epstein explained that the Ministry wishes to present a unified proposal by the end of the first quarter or

during the second quarter of 2010, in time for the passing of Israel's 2011 budget. Note: Proposing a new fiscal rule in 2010 may not give the rule influence over the drafting phase of the 2011 budget as, by the likely time of the rule's passing through the Knesset, the Government of Israel will likely have already proposed the 2011 budget. When asked why the process of proposing a fiscal rule to the government will take so long, Mr. Epstein explained that he personally wishes to speed up negotiations, but senior Ministry of Finance officials have not taken a strong interest in the creation of a rule. He urged the United States to press Minister Steinitz on the implementation of a new rule if it is a U.S. economic priority, and suggested that we propose to use loan guarantee conditionality if the Minister needs political cover to push through the rule.

Where would a fiscal watchdog be housed?

¶8. (C/NF) Although all three entities were generally in agreement over the need for further independent oversight over Israel's annual budget, two competing ideas exist over where the CBO-like "watchdog" should be housed. One idea, championed by the Bank of Israel, is to house the oversight body within the nascent Knesset Research Service as it would allow Knesset members to serve as a check on the government's spending projections as well as allow the government to check Knesset spending proposals it considers too costly. However, the Research Service does not have a direct advisory role to the Prime Minister, whose office ultimately decides the budget's priorities and projections.

¶9. (C/NF) The second proposal, loosely advocated by the Ministry of Finance and the National Economic Council, suggests a natural place for the oversight body as part of the NEC. As the NEC is the direct advisor to the Prime Minister, but is vested with a degree of political independence, the MoF and NEC argue that it has the capacity to influence the spending plans and the projections written into the budget and ultimately approved by Netanyahu himself. The MoF also sees the NEC as a potential ally close to the Prime Minister-something the MoF sees as necessary given its private complaints that Prime Minister Netanyahu "steamrolled" the MoF during the 2009-10 budget-making process. The BoI, however, worries that the political clout of the NEC is very personality-dependent, and future Prime Ministers may not value the advice of the Council if its leader is not a close ally of the PM. All three institutions, however, argue that creating a new organization to serve as a fiscal watchdog is unfeasible due to the personnel constraints of the Israeli government, and the already large number of players on the Israeli economic scene.

The way forward

¶10. (C/NF) Treasury recommends the following as a USG coordinated approach:

-- Encourage senior Ministry of Finance officials to enact a new, effective fiscal rule as soon as it is politically feasible to do so. A new rule must be written into law before the start of Israel's next (2011) budget drafting process for it to be effective before the end of the U.S. loan guarantee program in 2011. It also appears that all the working-level actors in the Israeli government are ready to move forward on presenting a new rule to the cabinet, and only require senior MoF buy-in to move forward at a more accelerated pace. Sustained interagency attention to the fiscal rule issue would help demonstrate the USG interest in the issue, and spur the Ministry of Finance to take speedy action.

-- Emphasize the need for Israel's new fiscal rule to effectively guide medium-term spending. Even if one-off emergencies may create significant uncertainty in Israel's spending outlook, they would only serve to exacerbate an

already difficult fiscal situation if Israel does not control the glide path of its existing spending commitments.

-- Stress the need for a fiscal oversight body for Israel, and encourage senior Israeli policymakers to investigate possible existing candidates. Sustained U.S. attention to the fiscal watchdog issue could help spur the GoI to take more immediate and substantive action. Ministry of Finance Director for International Affairs Oded Brooke reports that the new head of the Ministry of Finance's Budget Department, Udi Nissan, is interested in creating additional budget watchdog mechanisms in Israel.

-- Reach out to the NEC, BoI, and MoF before the JEDG Mid-Year Review to discuss how changes to conditionality could help Israel adopt a new fiscal rule and strengthen budget oversight. Broad government buy-in is necessary for action on fiscal reform now that the Prime Minister himself is a major player in economic decision-making.

-- Reach out to the Knesset Finance Committee and Knesset Research Service, discuss with them the U.S. interest in Israeli economic affairs, and encourage them to play a more active role in economic policymaking. Both institutions could play a stronger role in the creation of a new fiscal rule and serve as oversight mechanisms for the government's budget and fiscal path. An enhanced Knesset role may also help strengthen government buy-in to a new fiscal rule. In the past, government actors have not seen the rule as strongly binding because they viewed it as negotiated and pushed through by a small clique of economic technocrats.

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